

**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001**

**RECEIVED
SEP 13 3 04 PM '00**

**POSTAL RATE COMMISSION
OFFICE OF THE SECRETARY**

POSTAL RATE AND FEE CHANGES, 2000)

Docket No. R2000-1

**INITIAL BRIEF

OF

DISTRICT PHOTO, INC.,
MYSTIC COLOR LAB, AND
COX SAMPLING**

**William J. Olson
John S. Miles
WILLIAM J. OLSON, P.C.
8180 Greensboro Drive, Suite 1070
McLean, Virginia 22102-3860
(703) 356-5070**

**Counsel for
District Photo, Inc.,
Mystic Color Lab, and
Cox Sampling**

September 13, 2000

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 2000)

Docket No. R2000-1

INITIAL BRIEF

OF

DISTRICT PHOTO, INC.,
MYSTIC COLOR LAB, AND
COX SAMPLING

William J. Olson
John S. Miles
WILLIAM J. OLSON, P.C.
8180 Greensboro Drive, Suite 1070
McLean, Virginia 22102-3860
(703) 356-5070

Counsel for
District Photo, Inc.,
Mystic Color Lab, and
Cox Sampling

September 13, 2000

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iii
STATEMENT OF THE CASE	1
SUMMARY OF ARGUMENT	5
ARGUMENT	
I. BACKGROUND	
A. Standard A Parcels Have High Value	6
B. The Postal Service's Flawed Approach to Parcels	7
C. Standard A Parcel Volumes are Plummeting	8
D. Postal Service Method of Estimating Parcel Costs	9
E. The Postal Service Focuses on Costs and Ignores Revenue	10
II. THE PROPOSED RESIDUAL SHAPE SURCHARGE IS BASED ON UNRELIABLE COST DATA	
A. Standard A Parcel Costs Are Said to Have Exploded	12
B. Asserted Parcel Cost Changes Must Be Viewed in Perspective, Vis-a-Vis Movements in Flat and Letter Costs	
1. The Postal Service's Response to POIR No. 4.	13
2. Trends in Postal Service Costs	17
C. Postal Service Estimates of Unit Cost of Standard A Parcels Have Grown Far More Dramatically than Even Those of Periodicals	22

III.	THE POSTAL SERVICE HAS BADLY NEGLECTED STANDARD A PARCELS, AND HAS FAILED TO ACQUIRE THE KNOWLEDGE OR EVIDENCE THAT WOULD JUSTIFY AN INCREASE IN THE RESIDUAL SHAPE SURCHARGE	24
A.	IOCS Cost Data Cannot Explain Supposed Increases in Parcel Costs	24
B.	The Mismatch of Parcel Costs and Volumes	25
C.	Ignorance Concerning Parcel Handling Costs Combined with Rate Hikes Leads to Unintended Consequences	27
IV.	THE POSTAL SERVICE'S REQUESTED INCREASES IN THE STANDARD A RESIDUAL SHAPE SURCHARGE WOULD FURTHER GRIEVOUSLY WOUND A WEAKENED PRODUCT, AND SHOULD NOT BE RECOMMENDED	31
	CONCLUSION	35

TABLE OF AUTHORITIES**Page****Statutes**

39 U.S.C. section 3622 1, 6, 31

39 U.S.C. section 3623 1

Regulations

39 CFR 3001.20 2

Postal Rate Commission Opinion and Recommended Decisions

Docket No. R90-1 31

Docket No. R97-1 13, *passim*

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 2000)

Docket No. R2000-1

INITIAL BRIEF

OF

DISTRICT PHOTO, INC.,
MYSTIC COLOR LAB, AND
COX SAMPLING

STATEMENT OF THE CASE

Course of Proceedings

On January 12, 2000, the United States Postal Service filed a request, pursuant to the Postal Reorganization Act (39 U.S.C. sections 3622 and 3623), for a recommended decision by the Postal Rate Commission on certain rates and fees, including proposals relating to Standard A Mail rates, as well as certain changes to the Domestic Mail Classification Schedule.

On January 14, 2000, the Commission issued a Notice of Filing of the Postal Service's submission, which Notice of Filing, *inter alia*, established procedures and proposed schedules for the new docket (designated as Docket No. R2000-1) regarding

consideration of the Postal Service's requested changes by the Commission (Order No. 1279).

In accordance with Order No. 1279 and Rule 20 of the Commission's Rules of Practice and Procedure (39 CFR section 3001.20), District Photo, Inc. and Cox Sampling filed notices of intervention on February 15, 2000, and Mystic Color Lab filed a notice of intervention on February 16, 2000. These three intervenors have proceeded jointly in this proceeding, and are referred to collectively as "DMC."

The Postal Service's Request

The Postal Service's Request for a Recommended Decision initiating this proceeding requested rate and fee changes affecting all classes of mail, and asserted that without those changes the Postal Service would incur a revenue deficiency of \$3.7 billion in the requested test year (FY 2001). According to the Postal Service's initial filing, the requested rates essentially would result in financial break-even (generate a revenue deficit of approximately \$21.8 million in the test year).

The Postal Service's case-in-chief requested an increase in the residual shape (nonletter, nonflat) surcharge from 10 cents to 18 cents for Standard A Regular parcels, an increase from 10 cents to 15 cents for Standard A ECR parcels, and implementation of a new 3 cent per-piece barcode discount for Standard A Regular parcels.

Discovery of the Postal Service's Case-in-Chief

DMC conducted written cross-examination of two Postal Service witnesses with respect to their identified direct testimony, which appears in the record at the pages identified below:

Witness Charles L. Crum (USPS-T-27) Tr. 8/3365-99

Witness Joseph D. Moeller (USPS-T-35) Tr. 10/3841-53

Counsel for DMC conducted oral cross-examination of the same two Postal Service witnesses, which appears in the record at the following identified pages:

Witness Crum Tr. 8/3472-514

Witness Moeller Tr. 10/4109-23

Direct Testimony of Other Intervenors

The Parcel Shippers Association ("PSA") sponsored the direct testimony of witness Win Zimmerman (PSA-T-1) concerning the proposed increase to the Standard A residual shape surcharge (Tr. 29/14121-50). PSA opposes the proposed increases, and witness Zimmerman testified concerning the substance of, and the foundation for, that opposition. There was no cross-examination of witness Zimmerman regarding his opposition to the proposed parcel surcharge increases.

The Recording Industry Association of America, Inc., sponsored the direct testimony of witness Sander A. Glick (RIAA-T-1) concerning the Standard A residual

shape surcharge.¹ Witness Glick presented a theoretical basis for using revenue differences in the determination of the rate differential between Standard A flats and parcels. The written cross-examination of witness Glick appears at Tr. 23/10396-99. There was no oral cross-examination of witness Glick with respect to his testimony regarding the proposed increases to the parcel surcharge.

Rebuttal Testimony

No party filed rebuttal testimony on the proposed increases to the residual shape surcharge.

Interest of the Intervenors

This brief is presented on behalf of three intervenors. Two are photo finishers, District Photo, Inc., which does business as Clark Color Labs and York Photo, and Mystic Color Lab. Each firm is a through-the-mail film processor which receives exposed film through the mail, and uses the Postal Service to return developed film and prints to its customers. Cox Sampling distributes product samples on behalf of its clients. Each of the intervenors is a major user of the U.S. mails in terms of both quantity of items mailed and costs of postage. Each has an interest in the classification and rate changes proposed by the Postal Service herein, including a particular interest

¹ RIAA-T-1, Tr. 23/10388-94.

in the proposed increases in the Standard A Mail residual shape surcharge, and would be significantly affected by such proposed rate and classification changes.

SUMMARY OF ARGUMENT

The Postal Service's proposed increases to the Standard A residual shape surcharge should not be recommended by the Commission because of the lack of adequate foundation in the record for such increases, and because of the clearly deleterious effects such increases would produce.

The proposed parcel rate increases are being driven by an incredible, largely unexplained rise in Postal Service estimates of parcel costs: more than 50 percent between FY 1996 and FY 1998. These parcel cost estimates are highly questionable due to three factors. First, the Postal Service clings to an unfounded, complete reliance on the IOCS for detailed cost data, even though the IOCS clearly was never designed for such a purpose. Second, the Postal Service has consistently refused to undertake a proper cost study of Standard A parcels, despite calls for such studies from the Commission. Third, the Postal Service cannot provide any plausible operational explanation for the spike in its estimated costs.

The evidence is clear that the Postal Service's parcel business is not just waning; it is rapidly disappearing. Standard A parcels have been sorely neglected, and the proposed increase in the surcharge is the latest development in the Postal Service's apparently unreflective action regarding its Standard A parcel product. If the Postal Service has truly given thought to the effects of its action, its thinking must be

misguided, for the Service is choosing to ruin its own product, a particularly startling decision given that it comes unprovoked by demands from other Standard A mailers who supposedly would benefit from a high surcharge. DMC submits that the record evidence does not support the proposed parcel rate increase, and they respectfully request the Commission not to increase the current 10 cent rate.

ARGUMENT

I. BACKGROUND.

A. Standard A Parcels Have High Value.

Within the context of all Standard A Mail, commercial and nonprofit combined, parcels accounted for a comparatively small portion of the total revenue (3.0 percent) and total volume (1.1 percent) in Base Year 1998. The vast majority, about 90 percent, of Standard A parcels are mailed at the Regular commercial rate. Although parcels constitute only a small subset of Standard A Mail, they are important not only to those businesses that mail them, but also to their recipients. *See* 39 U.S.C. section 3622(b)(1), (4), and (5). Many parcels consist of the fulfilment of orders which recipients have placed with senders (*e.g.*, medical prescriptions, checks, prints from developed film, etc.), and the balance consists of valuable merchandise samples. It seems reasonable to conclude that recipients consider the contents of a Standard A parcel, on average, to be far more important than much other Standard A Mail, for example, unsolicited advertising circulars.

B. The Postal Service's Flawed Approach to Parcels.

The Postal Service fails to treat these parcels as having value to the senders, recipients, and the Postal Service — rather treating them as expendable. Witness Moeller (USPS-T-35), the Postal Service's Standard A rate design witness in this docket, proposes increases to the Standard A residual shape surcharge in his direct testimony.² As in Docket No. R97-1, witness Moeller relies on witness Crum's direct testimony as conclusively demonstrating a measurable difference between the costs incurred by flats and those incurred by residual Standard A mailpieces. A correct understanding of the evidence, however, establishes that witness Moeller's reliance is misplaced, for witness Crum's testimony is flawed.

Thus, because of a flawed cost foundation, witness Moeller proposes an 18 cent surcharge for **Standard A Regular parcels**. He characterizes the 8 cent increase in the Standard A Regular surcharge as "further[ing] the goal of greater recognition of the [parcel/flat] cost difference," mitigated by the availability of a 3 cent per-piece barcode discount.³

² USPS-T-35, pp. 6-8 (regarding Standard A Regular), and pp. 23-24 (regarding Standard A ECR).

³ USPS-T-35, p. 6.

For **Standard A ECR**, witness Moeller sets the proposed surcharge at 15 cents, reflecting “the net surcharge on Regular barcode-discounted parcels,”⁴ noting that ECR parcel costs “reflect the cost consequences of using [Detached Address Labels].”⁵

C. Standard A Parcel Volumes Are Plummeting.

The two Standard A commercial subclasses have experienced significant growth in volume, as well as revenue. Volume increased nearly 10 billion (16.5 percent) from FY 1996 to FY 1998, while revenues increased \$1.5 billion (14.3 percent).⁶

For the **parcel** component of Standard A, however, volume of commercial and nonprofit **mail fell** over this same time period by over 78 million (8 percent), and **revenues declined 4.6 percent**. Docket No. R97-1, USPS-T-28, Exhibit K, Table 1; Docket No. R2000-1, USPS-T-27, Attachment F, Table 1, Permit Estimate data. In FY 1999, the year during which the parcel surcharge was initially implemented, **parcel volumes fell another 80 million pieces (10 percent)**. The full impact of those rate increases on Standard A parcels can be expected to result in further volume decreases in FY 2000.

⁴ *Id.*, p. 23.

⁵ *Id.*, p. 24.

⁶ Library Reference USPS-LR-I-117.

D. Postal Service Method of Estimating Parcel Costs.

Witness Moeller states that the 18 cent surcharge reflects a 27.5 percent passthrough of the parcel/flat cost difference, comparable to the Commission's 24 percent passthrough in Docket No. R97-1.⁷ If so, the 80 percent increase in the surcharge has been driven by an incredible jump in estimated parcel costs — increases of nearly 50 percent for Standard A Regular and Nonprofit, and nearly 65 percent for Standard A ECR and Nonprofit ECR, between BY 1996 (Docket No. R97-1) and BY 1998, using the Postal Service's new cost methodology.⁸ According to witness Crum, the new cost methodology produces a unit cost differential of 65.8 cents between parcels (78.0 cents) and flats (12.2 cents), but that new methodology did not use "explicit econometric-based volume variability factors" as part of the Postal Service mail processing cost presentation, as had been done in Docket No. R97-1. USPS-T-27, p. 8, ll. 7-13. If those factors **had** been used, according to witness Crum, the unit costs for parcels would have been 67.7 cents, the unit costs for flats would have been 12.1 cents, and the unit cost differential would have been 55.6 cents. *See* Postal Service witness Crum Response to Question Posed at Hearings, Tr. 21/8419-20. A critical question for the Commission is whether the Postal Service's cost methodology accurately measures the differential, particularly since the Postal Service departed from its prior methodology.

⁷ *Id.*, p. 7.

⁸ Response to DMC/USPS-T27-8, Tr. 8/3377-78.

Witness Crum updates the underlying cost estimate by a test year/base year wage rate adjustment factor of 1.124,⁹ and estimates the Test Year 2001 cost difference between parcels and flats in bulk Standard Mail (A) as 74.0 cents.¹⁰ He further calculates that 0.4 cents of the 74.0 cent cost difference results from the deeper entry of flats, and that 8.1 cents results from the finer presort of flats.¹¹ Witness Crum's final estimate of the FY 2001 shape-related cost difference between Standard Mail A parcels and flats is 65.6 cents. This is the asserted cost basis supporting the Standard A residual shape surcharge proposed by the Postal Service in this docket.

E. The Postal Service Focuses on Costs and Ignores Revenue.

In attempting to justify the proposed increase in the residual shape surcharge, witness Moeller focuses on the parcel/flat cost difference, rather than a "revenue/cost relationship within shape."¹² He observes that witness Crum's testimony estimated a "revenue shortfall" for Standard A Regular parcels, even with the proposed surcharge. However, witness Moeller knew that witness Crum's testimony about a "revenue shortfall" does not reflect either the Postal Service's proposed proposed changes in the piece and pound rate, or the proposed parcel barcode discount.¹³

⁹ USPS-T-27, p. 10.

¹⁰ *Id.*, p. 11.

¹¹ *Id.*, Attachment F, Table 4.

¹² USPS-T-35, p. 7.

¹³ *Id.*

RIAA witness Sander A. Glick (RIAA-T-1, Tr. 23/10388-94) provided a brief, but useful, piece of testimony addressing the Commission's expressed need to have a theoretical basis for using revenue differences in determining the residual shape surcharge, as opposed to cost differentials. His testimony explains that, although witness Crum adjusted parcel costs for dropshipping and depth of presort, he failed to adjust for the substantial weight differences between parcels and flats. Witness Glick is right. To understand the effect of shape on cost, weight must be adjusted for as well. In order for the substantial difference in average weight is adjusted for, witness Glick estimated the weight-related cost difference between flats and parcels to be 20 cents, greatly moderating the supposed cost differences claimed by witness Crum. *Id.* Tr. 23/10392-93.

II. THE PROPOSED RESIDUAL SHAPE SURCHARGE IS BASED ON UNRELIABLE COST DATA.

A. Standard A Parcel Costs Are Said to Have Exploded.

The Postal Service's proposed Standard A parcel rate increases, which reflect changes in the general Standard A rates plus the residual shape surcharge, are driven by an asserted escalation in unit parcel costs. The costs attributed to Standard A parcels are estimated to have suddenly jumped by more than 51 percent from FY 1996 - FY 1998, after consecutive years of 5-6 percent decreases¹⁴ — an increase that is not due to any changes in parcel processing methodology.¹⁵ Of course, the Commission can do virtually nothing to control the Postal Service's rapidly escalating estimated unit costs, no matter how astonishing or outrageous they appear to be. The Commission can, however, exercise discretion as to whether it accepts the Postal Service's questionable cost data as accurately measuring implausibly large increases in costs in support of its proposed rate increases.

Standard A flat and letter costs did not see increases anywhere in this range. In fact, the Postal Service's estimated parcel/flat cost differential supposedly increased by 86 percent between FY 1996 and FY 1998. According to the Postal Service, the inflation-adjusted increase in Standard A parcel costs over the past decade has been even greater than the corresponding increase in Periodicals costs, which has been the

¹⁴ See attachment to response to PSA/USPS-T27-5(d), Tr. 8/3427-30. Ironically, witness Crum provided these data as support for the proposition, *inter alia*, that overall parcel unit cost data have been consistent from year to year.

¹⁵ Response to DMC/USPS-T27-8, Tr. 8/3377-78.

focus of substantial Commission concern. *See, e.g.*, Presiding Officer's Information Request ("POIR") No. 4, Docket No. R2000-1.

Witness Crum (USPS-T-27), has analyzed the costs of Standard A flats and parcels. As mentioned above, his estimated Base Year 1998 cost difference is 65.8 cents per piece.¹⁶ This is an increase of 30.3 cents (86.3 percent) over the 35.1 cent cost differential he developed in his Docket No. R97-1 testimony with respect to then Base Year 1996.¹⁷ As indicated above, however, witness Crum testifies that part of the expansion of the cost difference between flats and parcels in this docket, compared with Docket No. R97-1, may reflect the Postal Service's new costing methodology¹⁸ *See pp. 8-9, supra.*

B. Asserted Parcel Cost Changes Must Be Viewed in Perspective, Vis-a-Vis Movements in Flat and Letter Costs.

1. The Postal Service's Response to POIR No. 4.

If the Postal Service's cost estimates are to be believed, in less than 10 years the **inflation-adjusted** estimated unit cost of parcels has increased far more than any other Postal Service product. The Postal Service's response to POIR No. 4 provides wage rate adjusted unit cost data for First-Class Mail and Standard A letters, flats and parcels. They are set forth in Table 1, below. Small (under 16 ounce) parcels

¹⁶ USPS-T-27, p. 10.

¹⁷ Docket No. R97-1, *Op. & Rec. Dec.*, para. 5428.

¹⁸ USPS-T-27, p. 8.

constitute a rather minor portion of the subclasses in which they are entered.

Consequently, IOCS samples are comparatively small and the year-to-year unit costs often exhibit a considerable amount of stochastic variation. To compensate for such year-to-year instability, three-year averages have been taken from the data in the tables provided in response to POIR No. 4, for (1) 1989-1991, which represent the first three years of available data, and (2) 1997-1999, the last three years. The analysis in Table 1 is restricted to the sum of mail processing and in-office city carrier costs, thereby further reducing the statistical variation that inevitably occurs with more limited data sets such as the individual components of unit cost.

The results summarized in Table 1 are revealing with respect to Postal Service costs. Letters are shown first, followed by flats, then parcels. The average unit cost for 1989-1991 is shown in column 1, and the average unit cost for 1997-1999 is shown in column 2. Inflation has been removed from the mail processing and in-office delivery costs via the adjustment for changes in the wage level. Consequently, the percentage changes shown in column 3 represent cost changes due to factors other than general wage inflation. A dramatic increase in parcel costs, vis-a-vis the costs of flats and letters, is evident from those data

If the Postal Service's cost estimates are accurate, during the 1990's the Postal Service developed new and increasingly expensive ways to handle parcels, and it now wants to pass those unexplained cost increases to mailers through extraordinary rate hikes. On the other hand, even if the Postal Service's estimates are not accurate, the Postal Service asks the Commission to rely on the estimates to impose extraordinarily

high rate increases on parcel mailers. In either case, the Postal Service requests the Commission to make mailers of Standard A parcels the victims of Postal Service mistakes.

Table 1

Comparison of Changes in Mail Processing Plus Carrier
In-Office Units Costs, Wage Level Adjusted
1989-1991 Average vs. 1997-1999 Average
(cents)

	(1) 1989 -91 Average Unit Cost MP+In-Office City Carrier Wage-level Adjusted	(2) 1997-99 Average Unit Cost MP+In-Office City Carrier Wage-level Adjusted	(3) Percent Increase (Decrease)
LETTERS			
First-Class:			
Single piece	9.9	8.7	-12.0%
Non-carrier route presort	5.4	3.4	-35.9%
Standard A:			
Regular	6.2	3.9	-38.1%
ECR	2.6	1.5	-42.0%
Nonprofit	4.3	3.4	-20.9%
Nonprofit ECR	2.0	1.8	-11.9%
FLATS			
First-Class:			
Single piece	20.9	21.3	2.1%
Non-carrier route presort	8.4	20.7	145.5%
Standard A:			
Regular	8.5	7.4	-12.9%
ECR	1.6	1.3	-13.8%
Nonprofit	5.7	7.9	39.1%
Nonprofit ECR	1.3	1.9	45.0%
Periodicals	7.2	7.6	5.8%
PARCELS/PPs			
First-Class:			
Single piece	21.5	34.5	60.2%
Non-carrier route presort	2.7	35.5	1220.7%
Standard A:			
Regular	15.3	22.9	49.1%
ECR	6.8	64.1	845.5%
Nonprofit	11.3	33.7	197.8%
Nonprofit ECR	3.6	131.2	3581.8%

Source: Response of United States Postal Service Witness Smith to POIR No. 4, Tr. 46D/21807-22.

Letters. As the Commission observed in POIR No. 4 and Order No. 1289, the inflation-adjusted unit cost for letters has generally declined.

Flats. For flats, the Postal Service's estimated unit costs are generally up. For reasons unexplained, in the 1997-1999 time frame, the average unit cost for presorted flats was almost as high as the unit cost for single piece flats. These cost estimates are counter-intuitive, since presorted flats ought to avoid a number of expensive handlings.

Periodicals. For periodicals, inflation-adjusted unit costs had a clear downward trend through 1993, followed by a sharp upward trend, which is shown clearly in Commission Order No. 1289, Attachment A, page 4. *See* section I. C. *infra*.

Parcels. The inflation-adjusted unit cost increases estimated for First-Class Mail and Standard A parcels are nothing short of astounding, especially when compared to letters and flats. In recent years, small parcel processing costs have escalated dramatically beyond the rate of inflation (as reflected by the Postal Service wage rates) to the point where they appear to be either **badly misestimated** or **totally out of control**. In either event, the Postal Service proposes to impose the penalty for one of these two faults of the Postal Service on the mailers of these parcels.

2. Trends in Postal Service Costs.

The cost data for all years provided in the Postal Service's response to POIR No. 4 have been used to compute a three-year moving average of mail processing plus in-office city carrier costs for parcels. Such a moving average helps smooth year-to-year fluctuations in parcel costs, and provides a better demonstration of the underlying trend in wage-level adjusted costs. The results are shown graphically in the following

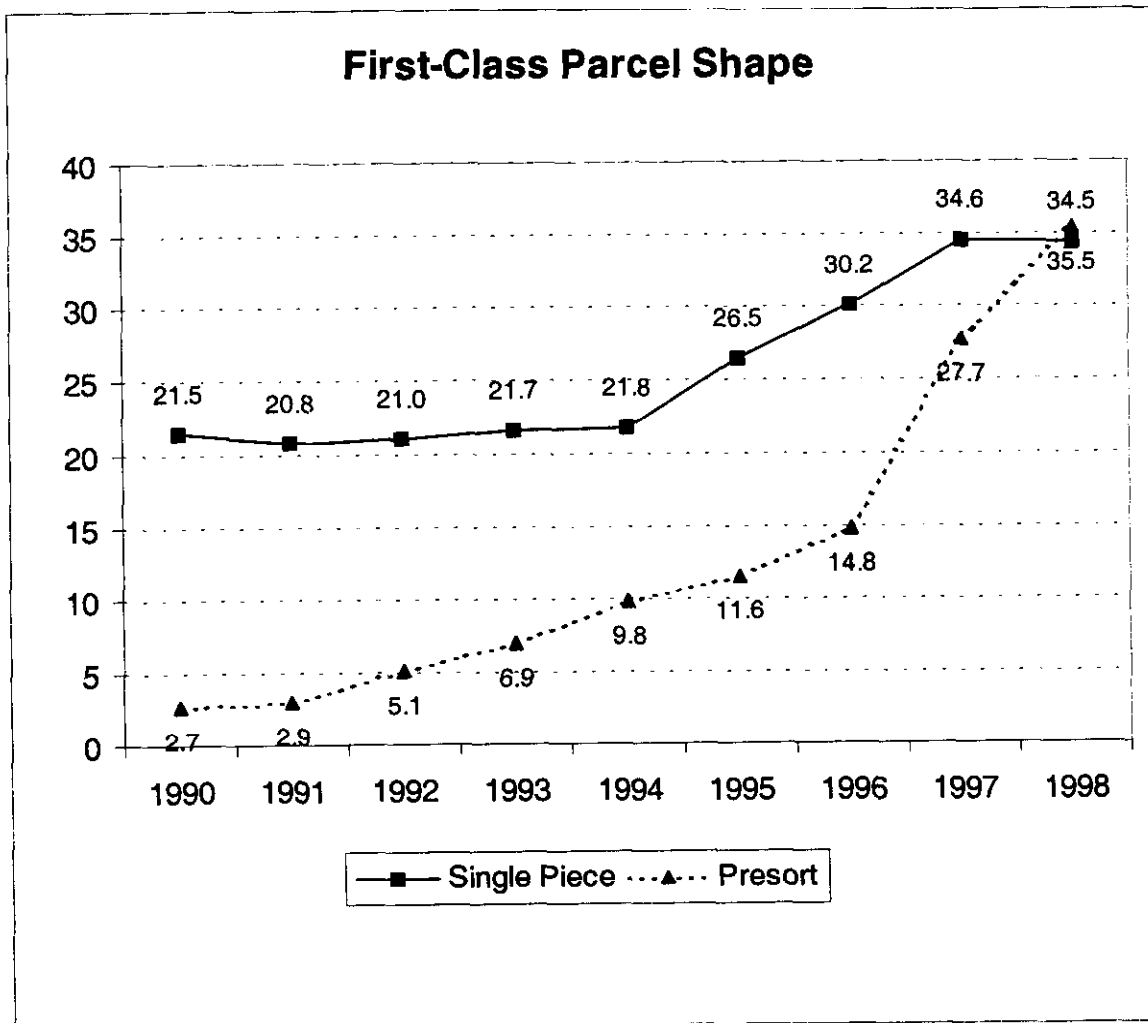
Figures 1, 2 and 3. These figures illustrate, respectively, for First-Class Mail, Standard A Commercial, and Standard A Nonprofit, Postal Service estimated unit mail processing costs and city carrier in-office costs with respect to parcels for the years 1990-1998.

Although each subclass has experienced a marked increase in the inflation adjusted unit cost, the results vary dramatically. Counter-intuitively, presortation, rather than ameliorating cost increases, appears to have been a propellant. The costs of First-Class Mail Presort, Standard A ECR and Standard A Nonprofit ECR have, figuratively speaking, taken off like a rocket. Raising additional questions about the reliability and representation of the cost data, during 1997-1999, the average unit cost in each of these "more presorted" subclasses exceeded the unit cost in the corresponding "less presorted" subclass.¹⁹

¹⁹ DMC filed a Motion Requesting That the Postal Service Be Directed to Submit Evidence on Parcel Processing Costs to force the Postal Service to explain why parcel costs were so badly out of control. The Presiding Officer's Ruling relating to the DMC motion said that three-year moving averages were "frequently an excellent way to smooth data in order to recognize trends," but misleading as a way to recognize the apparent trends in this instance. (Presiding Officer's Ruling No. R2000-1/45, p. 2.) Even if specific year-to-year trends cannot be established by moving data averages, however, the moving averages do show broad trends toward parcel costs being out of control or data being unreliable. *See, e.g.,* Presiding Officer's Ruling No. R2000-1/45, p. 2, fn. 4.

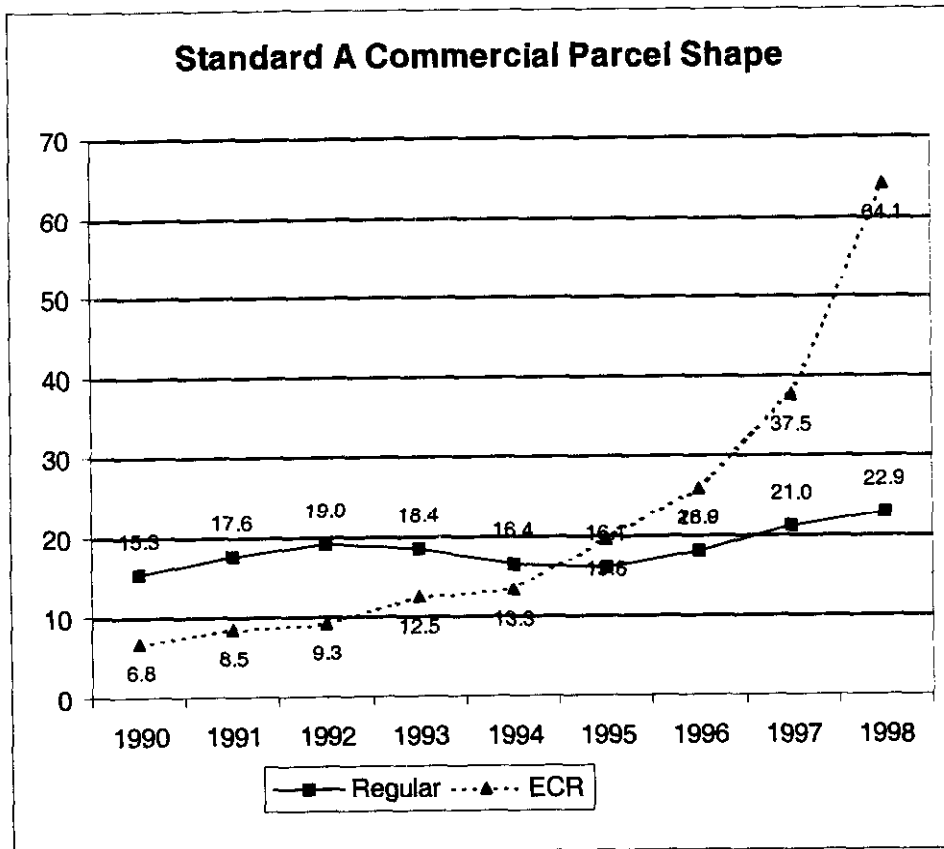
Figure 1

Mail Processing Plus City Carrier In-Office Unit Cost Cents per piece
 Wage Level Adjusted to FY 1989
 (three-year moving average)



Source: Response of United States Postal Service Witness Smith to POIR No. 4 (March 17, 2000), Tr. 46D/21807-22. See DMC Motion Requesting that the Postal Service be Directed to Submit Evidence on Parcel Processing Costs (April 4, 2000), Attachment A; Tr. 8/3511.

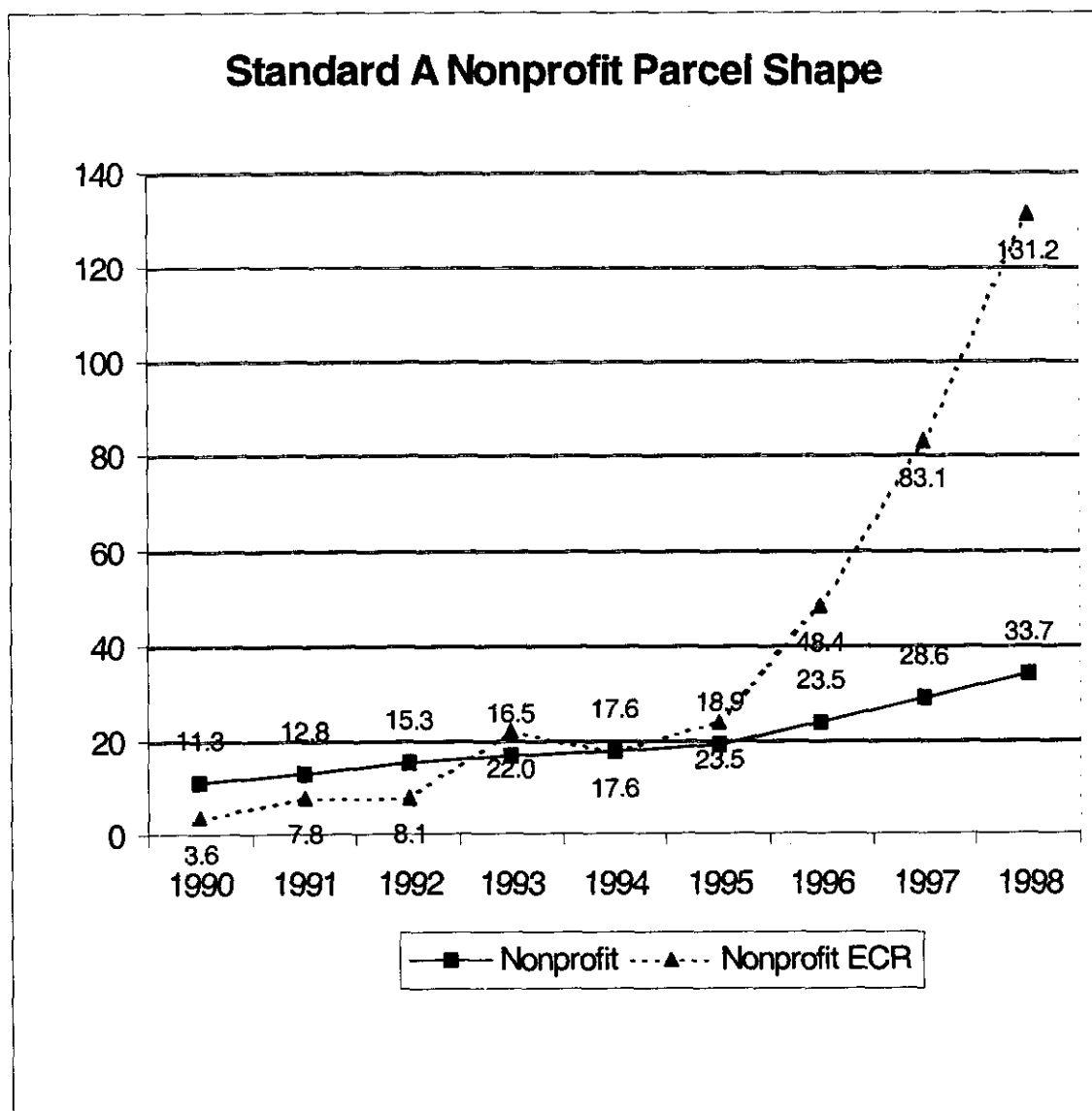
Figure 2
 Mail Processing Plus City Carrier In-Office Unit Costs
 Cents per piece, Wage Level Adjusted to FY 1989
 (three-year moving average)



Source:

Response of United States Postal Service Witness Smith to POIR No. 4 (March 17, 2000), Tr. 46D/21807-22. See DMC Motion Requesting that the Postal Service be Directed to Submit Evidence on Parcel Processing Costs (April 4, 2000), Attachment B; Tr. 8/3512.

Figure 3
 Mail Processing Plus City Carrier In-Office Unit Costs
 Cents per piece, Wage Level Adjusted to FY 1989
 (three-year moving average)



Source: Response of United States Postal Service Witness Smith to POIR No. 4 (March 17, 2000), Tr. 46D/21807-22. See DMC Motion Requesting that the Postal Service be Directed to Submit Evidence on Parcel Processing Costs (April 4, 2000), Attachment C; Tr. 8/3513.

C. Postal Service Estimates of Unit Cost of Standard A Parcels Have Grown Far More Dramatically Than Even Those of Periodicals.

In Order No. 1289, the Commission expressed concern about the increasing unit cost of periodicals after adjusting for inflation. Since 1993, the estimated inflation-adjusted unit cost of periodicals has increased by approximately 20 percent, from 6.49 to 7.74 cents. The Commission's focus on the increase in periodicals costs is well founded, but the cause for concern about Standard A parcel costs should be even greater. As demonstrated below, the problem with Standard A parcel costs is fully **three times as serious** as that regarding periodicals costs.

In order to compare the unit costs of Standard A parcels with those of periodicals, a weighted average of parcel costs was computed, and the unit costs for periodicals and Standard A parcels were reduced to an index. The results are shown in Table 2, below, where the "Unit Cost" columns are taken from the Postal Service's response to POIR No. 4, and constitute the foundation for the "Index" column. Since 1993, the unit cost for periodicals has increased by about 20 percent, while the unit cost for Standard A parcels is up three times as much, or by 60 percent. Looked at another way, since 1989 the unit cost of parcels has supposedly more than doubled. Although the parcel data may be subject to a significant error, they indicate a sharp rise in the cost of handling parcels, even before the surcharge took effect.

Table 2

**Wage-Adjusted Mail Processing and In-Office City Carrier Unit Costs
of Periodicals and Standard A Parcels
1989 - 1999**

Year	Unit Cost (cents)		Index (1993 = 100)	
	Periodicals (1)	Parcels (2)	Periodicals (3)	Parcels (4)
1989	7.32	13.6	113	75
1990	7.15	13.7	110	76
1991	6.98	16.7	108	92
1992	6.59	20.2	102	112
1993	6.49	18.1	100	100
1994	6.66	15.6	103	86
1995	6.83	15.1	105	83
1996	7.01	18.6	108	103
1997	7.16	22.6	110	125
1998	7.79	25.8	120	143
1999	7.74	29.0	119	160

Source: Response of United States Postal Service Witness Smith to POIR No. 4, Tr. 46D/21807-22.

II. THE POSTAL SERVICE HAS BADLY NEGLECTED STANDARD A PARCELS, AND HAS FAILED TO ACQUIRE THE KNOWLEDGE OR EVIDENCE THAT WOULD JUSTIFY AN INCREASE IN THE RESIDUAL SHAPE SURCHARGE.

In Docket No. MC95-1, the Commission requested that the Postal Service study Standard A parcels. Although the Commission did not spell out specifically what it had in mind, presumably it meant that the Postal Service should do more than an IOCS-based cost study.

A. IOCS Cost Data Cannot Explain Supposed Increases in Parcel Costs.

The substantial increase in the estimated cost of handling parcels is largely unexplained. In part, this is because most of the data derive from an IOCS-based study, which typically explains little or nothing about the characteristics of mail which drive costs.²⁰

The IOCS database is large, complex and expensive to maintain. It seems to have a seductive, siren-like call that blinds the Postal Service to the inadequacy of its use for missions for which it was never designed. An IOCS-based cost study for a category of mail with a small volume such as Standard A parcels has a number of shortcomings. First, a number of anomalies and gross inconsistencies arises because of the extremely small sample size in three of the four Standard A subclasses. The Postal Service can only hope that by focusing on the aggregated data for all four subclasses,

²⁰ Likewise, the basis for the Residual Shape Surcharge in Docket No. R97-1 was a study that used IOCS tallies to distinguish mail processing and in-office delivery costs for letters, flats and parcels.

these problems can be buried within the workpapers. Worse, however, is the rigidity of the IOCS, which prevents its prompt adaptation to the analysis of new issues as they arise. The IOCS tallies mechanically record characteristics of the work process as they fall into predetermined categories, defined by the requirements of time and motion studies going back generations, long before the Postal Service adopted widespread automation, let alone advanced information processing techniques. The Postal Service's obstinate clinging to IOCS as a source of answers to all questions impairs its ability to design proper cost studies to understand better numerous issues of great current interest. Reliance on the IOCS also leads to mismatches of costs and volumes, including those for Standard A parcels.

B. The Mismatch of Parcel Costs and Volumes.

Concerns regarding the adequacy of IOCS data to record Standard A parcel costs and volumes accurately have been raised in prior dockets. *See, e.g.*, Docket No. R97-1, *Op. & Rec. Dec.*, paras. 5440, 5441. However, as the Postal Service has acknowledged in the current docket, this problem will only grow worse.

An important reason for the Postal Service's cost data problems is the lack of coordination between data collected by the In Office Cost System ("IOCS") and those collected by the Revenue, Pieces and Weight ("RPW") system. As with all subclasses of mail, the unit cost for parcels is computed by the formula:

$$\text{Unit Cost} = \frac{\text{Total Cost [IOCS]}}{\text{Total Volume [RPW]}}$$

Mail processing and city carrier in-office costs are estimated by the IOCS, while volume data are compiled by the RPW system. In order to develop unit cost estimates that can be used as the basis for ratemaking, it is essential that data in the numerator and the denominator be compiled on a consistent basis by the IOCS and RPW systems.

The essence of the problem is described by witness Crum.²¹ It involves pieces that meet the dimension and preparation requirements for flats in all particulars but thickness, and have a thickness between 0.75 inches and 1.25 inches. All such pieces which meet the preparation requirements for the FSM 1000 Flat Automation rate (including bearing a barcode) are considered flats for postage payment purposes; *i.e.*, the RPW system will record the volume as flats. At the same time, the IOCS will record all such items as parcels because their thickness exceeds 0.75 inches. The effect upon the computation of the unit cost of parcels is to remove volume from the denominator while adding costs to the numerator. The net effect of this inconsistent recording is a systematic increase in the unit cost of parcels computed from the recorded data.

Inasmuch as this particular problem only started in FY 1999, it does not infect the Base Year data, nor does it explain any of the cost increases in excess of inflation since 1989. At the same time however, the problem could be a major source of error in unit costs for FY 1999 and years thereafter. The surcharge gives mailers a significant incentive to migrate whatever pieces they can to the automated flats category for

²¹ USPS-T-27, pp. 7-8, and response to RIAA/USPS-T27-2, Tr. 8/3433-4.

revenue purposes. And the number of such items is sufficient to cause Postal Service witness Kingsley to note the problem.²²

Witness Crum predicts that the migration of pieces 0.75 to 1.25 inches thick to the automated flats category will cause an increase in the unit cost of those pieces that cannot migrate from the parcels category. This prediction is guaranteed to be self-fulfilling if the RPW and IOCS continue to record data in an inconsistent manner.

C. Ignorance Concerning Parcel Handling Costs Combined with Rate Hikes Leads to Unintended Consequences.

Following are some of the gaps in knowledge and consequences that flow from the Postal Service's failure to look into the issues regarding Standard A parcels. At present: (1) no effort has been made to ascertain whether the ability to send small, under 16-ounce parcels at reasonable cost generates a significant volume of highly profitable Standard A Mail, First-Class Mail, or Priority Mail²³; (2) no one knows whether non-machinable parcels have a significantly higher cost than machinable parcels; (3) nor does anyone know whether some shapes have materially higher costs than other shapes; and (4) the effect that the weight of parcels has on costs incurred is also unknown. Average cost for each of the four subclasses individually and all four

²² USPS-T-10, pp. 16-17.

²³ In other words, the Postal Service has embarked on its parcels "strategy" with no systematic inquiry as to whether it might not "kill the goose that lays the golden eggs." In this docket, the Postal Service's presentation again avoids this important question.

subclasses combined, with a high coefficient of variation, is all that is available on the record.

The bottom line is this: neither the Postal Service, nor the Commission, nor anyone else yet knows (1) whether all parcels have a roughly similar cost, or (2) whether the revenue and handling characteristics of some parcels make those particular parcels reasonably profitable, while others are highly costly and non-remunerative in relation to the revenue which they generate, or (3) whether parcels yield "external economies" by helping the Postal Service generate a significant amount of highly profitable business, such as Priority Mail dropship.²⁴ This means, of course, that the residual shape surcharge, applied across the board to all parcels, may be having the unintended consequence of driving the more profitable parcels out of the residual shape parcel subset (and maybe out of the Parcel Service altogether).

Witness Haldi's testimony concerning the non-standard surcharge filed in Docket No. R97-1 discussed the redesign of packages to convert them into flats, where the nature of the contents makes such action feasible; *e.g.*, prints made from developed rolls of film, Christmas cards, check books, etc., could conceivably be packaged in different ways so as to reduce the thickness and enable the resulting packages to be classified as flats. See Docket No. R97-1, *Op. & Rec. Dec.* paras. 5431, 5461 and Tr.

²⁴ The volume of First-Class Mail and Priority Mail revenue which mailers of Standard A parcels generate for the Postal Service probably is quite substantial in comparison to the total Standard A postage (including the surcharge).

23/12144-49.²⁵ The subset of parcels capable of converting and migrating are possibly among the least costly items to handle within the IPP/parcels category. Consequently, any substantial migration of such parcels to flat-shaped items could have the effect of increasing the average cost of the remaining IPPs and parcels that cannot or do not migrate.²⁶

In its *Opinion and Recommended Decision* in Docket No. R97-1, the Commission rejected this part of witness Haldi's testimony as "speculative," with the anticipation that "undesirable outcomes from the unlikely prospect of mailer repackaging can be handled as they arise."²⁷ As noted above, however, significant declines in Standard A parcel volume have already occurred, with additional declines expected. These volume declines are here being met by the Postal Service with another round of dramatic increases to the residual shape surcharge — a response which, if applied repeatedly, would appear designed to kill off the Standard A parcel product. In each successive rate case, the Postal Service and the Commission may be faced with a smaller volume of Standard A parcels, with the unit cost of those parcels that remain in the postal system higher than in the previous case.

²⁵ Such flats would tend to be rigid, and might be machinable only on the FSM 1000.

²⁶ Such "redesigned" flats may have a higher unit cost than the average flat. Hence, any such shift may also increase the cost of flats, but considering the large volume of flats, the effect would be scarcely noticeable.

²⁷ Docket No. R97-1, *Op. & Rec. Dec.*, para. 5480.

Of course, serious study of parcels could lead to a different response by the Postal Service. Parcels can be classified into various segments, such as machinable, non-machinable, irregular outsides, etc. With such segmentation in mind, some important but unanswered questions are:

1. Which segments are experiencing the greatest decline in volume?
Machinable parcels? Non-machinable irregular pieces? The least expensive segments? The most expensive segments?
2. What are the principal factors that account for the decline in volume? Migration of parcel-shaped pieces to flats? A shift of business to alternate delivery companies? Or something else?

However, the Postal Service has been consistently unwilling to study the issues raised by the Commission. When the Commission recommends the Postal Service's proposed rate increases, the apparent effect is to remove any incentive from the Postal Service to give serious attention to that mail product.

At the very best, small parcels, such as those in Standard A, can be said to be suffering along with flats from only benign neglect. For example, the Small Parcel Bundle Sorter ("SPBS") has been around for many years, and newer, better machines do not appear to be on the near horizon. Substantial reductions in the unit costs of parcels are not likely until the Postal Service purchases radically better machinery.²⁸

²⁸ According to witness Kingsley (USPS-T-10), the Postal Service is investigating robots for (1) handling letter trays, and (2) to assist with the loading and unloading of parcels, bundle, pallets and packs in and out of containers (USPS-T-10, p. 23, ll. 6-8).

Standard A parcel mailers cannot afford a continued attitude of business as usual by the Postal Service. The Commission can give the Postal Service a wake-up call, by demanding that the Service conduct a reasonable study as the foundation for any significant rate change to Standard A parcels.

IV. THE POSTAL SERVICE'S REQUESTED INCREASES IN THE STANDARD A RESIDUAL SHAPE SURCHARGE WOULD FURTHER GRIEVOUSLY WOUND A WEAKENED PRODUCT, AND SHOULD NOT BE RECOMMENDED.

The Postal Service's entire Standard A parcel business appears to be in very serious trouble and could be threatened with extinction by the Postal Service's proposed rates. This increase will certainly act to further depress already-declining parcel volumes. Standard A parcel volumes fell by over 78 million (8 percent) from FY 1996 to FY 1998. They fell another 80 million (10 percent) in FY 1999, during the first year that the parcel surcharge was implemented. Moreover, since the rate increase was in effect for only nine months during FY 1999, on an annualized basis the decline may be even greater.

This precipitous decline in volume appears to be in direct response to rate increases. Implementation of the current 10 cent surcharge with the underlying rate changes implemented following Docket No. R97-1 caused the rate increases for Standard A Regular commercial parcels to range from 12 to 51 percent, depending upon the weight of the parcel. The term "rate shock" can fairly be used to describe

rate increases on this order of magnitude, especially when the systemwide average increase was in single digits.²⁹

Yet the Postal Service, in Docket No. R97-1, despite the warnings that were advanced by intervenors, refused to relent from its newly proposed parcel rate based upon a faulty cost analysis, profoundly misunderstanding the effect of double-digit rate increases on parcel volume. The Postal Service's estimate of FY 1998 Test Year After Rates Standard A parcel volume in Docket No. R97-1 was proven to be too high by an

²⁹ For a variety of reasons, the Postal Service and the Postal Rate Commission usually have limited the magnitude of rate increases. Certainly, 39 U.S.C. section 3622(b)(4) (*e.g.*, effect on mailers) demands such an effort. The Postal Service purports to take rate shock into account in setting rates. *See, e.g.*, cross-examination of USPS witness Moeller (USPS-T-35) Tr. 10/4121. Often, the upper limit has been set at approximately twice the average increase. For example, in Docket No. R90-1, where the Postal Service first introduced shape-based rates for third-class mail, Postal Service witness Mitchell:

identifies his initial policy guidance as an (i) overall constraint on the range of rate increases and decreases (no decreases greater than 10 percent and no increases greater than 35 percent) and (ii) the average 17 percent increase for regular rate and 23 percent for nonprofit. USPS-T-20 at 101; *Id.* at 73. Separate but related policy considerations — applied in a more category specific sense — include principles witness Mitchell describes as “honoring past relationships” and “easing the adjustment burden” on the mailers. We consider both of these part of his broad consideration of the impact or effect of the changes on mailers. [*Op. & Rec. Dec.*, Docket No. R90-1, p. V-235.]

Note that the Postal Service proposed an average increase of 17 percent, and a maximum rate category increase of 35 percent. In turn, the Commission recommended an average increase of 25 percent, and a maximum increase of 41.7 percent. *Id.*, p. V-246, n. 52. In this docket, the Postal Service proposes 50 to 80 percent residual shape surcharge increases, and seems to have entirely ignored the adverse impact of the proposed increases on Standard A parcel shippers.

amazing 295 million pieces. The Postal Service's estimate was nearly one-third higher than actual volume.³⁰

Witness Moeller asserts that "it is clear that the residual shape surcharge did not have an effect on the [1998 volume decrease] since it was not implemented in FY1998."³¹ However, his assertion is by no means certain; in fact, it seems incorrect. Mailers are not oblivious either to Postal Service rate increase filings, or ongoing Commission deliberation. Witness Haldi testified in Docket No. R97-1 that "one can predict with a high degree of confidence that virtually all parcel mailers whose product gives them a repackaging option will in fact seek to repackage their products into flat-shaped mailpieces if confronted with a significant surcharge for parcels."³² It is hardly inconceivable that the repackaging (and migration) of Standard A parcels into flats may have begun months before imposition of the punitive rate increases described above, particularly given the delayed implementation of rates from that docket.

In Docket No. R2000-1, the Postal Service has again donned rose-colored glasses when viewing the impact of its proposed rate increases on Standard A parcel volumes. The Postal Service proposes to compound the last docket's rate shock with another 50 or 80 percent increase in the surcharge. Yet the Postal Service blithely assumes "that the percentage of nonletter pieces which would be subject to the

³⁰ Response to DMC/USPS-T35-6, Tr. 10/3849.

³¹ *Id.*

³² Docket No. R97-1, NDMS-T-3, p. 14, ll. 5-8, Tr. 23/12145.

surcharge remains constant before and after rates.”³³ Based on the volume responses to the residual shape surcharge thus far discussed above, one can at the very least conclude that this assumption is not historically grounded.

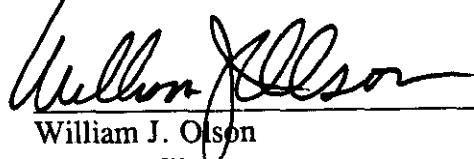
The Postal Service appears oblivious to the impact that would result from its proposed increases in the residual shape surcharge. Unfortunately, it appears to lack any demonstrable concern regarding the future of Standard A parcels, for the mailers who utilize this product, or for the other mail that may be generated in connection with these parcels.

³³ USPS-T-35, Appendix 1, p. 4. On the other hand, this prognostication appears somewhat at odds with later Postal Service estimates. For example, the Postal Service’s estimate of Test Year After Rates volume of Standard A Regular commercial parcels — the subclass which has almost 90 percent of all Standard A parcels — is projected to decline by 25 percent. The volume of ECR commercial parcels (already a much smaller category) is projected to decline by 50 percent. Response to PostCom/USPS-T-35-2, Tr. 10/3930-1.

CONCLUSION

For the foregoing reasons, DMC respectfully requests that the Postal Service's proposal for increases in the Standard A residual shape surcharge be rejected.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "William J. Olson", written over a horizontal line.

William J. Olson

John S. Miles

WILLIAM J. OLSON, P.C.

8180 Greensboro Drive, Suite 1070

McLean, Virginia 22102-3860

(703) 356-5070

Counsel for

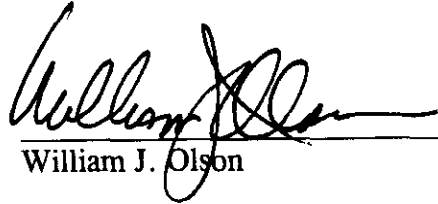
District Photo, Inc.,

Mystic Color Labs, and

Cox Sampling

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.



William J. Olson

September 13, 2000